TONGE INVESTMENTS
Registered Investment Adviser

The Tonge Telegraph
June 2008

Such a Pickle

The Federal Reserve Board has this little problem, you see. The Board has reduced interest rates to head off a recession but now faces inflationary pressures. This is not unprecedented, of course. The whole point of reducing interest rates is to make it easier for money to flow through the system—the grease, if you will, for the cogs in the economy. You have to apply a lot of grease to keep a rusty old temperamental machine running in a rainstorm. And the Fed has done just that. Now that they have prevented (one hopes) the economy from seizing up, they risk inflation spinning out of control.

Again, facing an inflation problem is not anything new, given the current circumstances. Allan Greenspan faced this same problem after rates were reduced last time. The huge difference now is the role that the cheap dollar is playing. A low dollar is a good thing to have when the economy is suffering because it makes our goods cheaper for people in other countries to buy. It also helps industries like tourism because it is relatively cheap for people to visit the US. Unfortunately, however, oil is priced in dollars, and so a dollar just doesn't buy as much as it did last year.

Energy prices are now biting deep into family and corporate budgets. Greenspan had a relatively easy time increasing interest rates because the economy started moving forward in a slow but textbook fashion. That is not likely to happen this time. Family budgets are finally feeling the effect of high energy prices. Energy is not a deferrable cost like purchasing a new car, which we could put off until next year. We have to pay for energy, in its many forms, today. The higher cost of energy depletes the money people might normally have for discretionary items—things you want but don't have to have right now. The discretionary spending fuels the economy.

But circumstances today are way different. Fed Chairman Bernanke needs and wants to raise rates to hold back inflation but it is going to be tough. The high cost of energy means families have less disposable income, and it increases the cost of almost all other goods and services we have to buy. Everything has to get from There to Here, and the ripple effect becomes a bad day at the beach. Workers need more wages to provide for their families, prices are increased to compensate for rises in both energy and payroll, and profits get squeezed because there just isn't enough room to maintain margins. It is a classic dilemma: raise rates and the Fed creates another burden on both personal and corporate finances . . . which prolongs the recessionary environment . . . wait too long to raise rates and inflation spirals out of control.   I believe I'll add "Chairman of the Federal Reserve" to the list of jobs I don't want to hold.

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